

CHAPTER 1

CHINA'S INDUSTRIAL, INVESTMENT AND EXCHANGE RATE POLICIES

“ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS. *The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China’s national budget and assess China’s fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.”* [P.L. 108–7, Division P, Sec. 2(c)(2)(B)]

“CORPORATE REPORTING. *The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.”* [P.L. 108–7, Division P, Sec. 2(c)(2)(E)]

KEY FINDINGS

- In 2003, the United States ran a goods trade deficit of \$535.5 billion, of which \$124 billion was attributable to the deficit with China.¹ The U.S. trade deficit with China constituted 23.2 percent of the total U.S. goods trade deficit and China was the largest single country component of the overall deficit. Goods exports to China in 2003 were \$28.4 billion, while imports totaled \$152.4 billion. China is heavily dependent on the U.S. market, with approximately thirty-five percent of its exports going to the United States, while only four percent of U.S. exports go to China.² The magnitude of the goods trade deficit threatens the nation’s manufacturing sector, a sector that is vital for national and economic security.
- The U.S. goods trade deficit with China has continued to worsen in 2004. In the first three months of 2004, the deficit rose from \$24.7 billion to \$ 30.2 billion, a more than twenty-two percent increase. The increase in the Advanced Technology Products (ATP) trade deficit has been proportionately even larger. In the first

three months of 2004, the ATP deficit rose from \$3.3 billion to \$6.3 billion, an eighty-nine percent increase.

- According to the Bureau of Economic Analysis, U.S. gross domestic product (GDP) growth in 2003 was 3.1 percent, and the worsening of the overall goods trade deficit lowered growth by 0.42 percent. The worsening of the U.S.-China trade deficit accounted for over one quarter of this negative contribution to growth.
- China is systematically intervening in the foreign exchange market to keep its currency undervalued. The undervaluation of the Chinese yuan has contributed to the trade deficit with China and has hurt U.S. manufacturing. This is because an undervalued yuan makes Chinese manufactured goods cheaper in the United States, while making U.S. manufactured goods more expensive in China. The undervalued yuan has also hurt the agricultural sector. Had the Chinese yuan appreciated, as dictated by market forces, this would have made U.S. agricultural products cheaper in China which in turn would have increased Chinese demand for these products. An immediate and significant upward revaluation of the Chinese yuan against the dollar, combined with the removal of discriminatory Chinese trade practices, should help reduce the U.S. trade deficit with China. There is also a need for other East Asian countries (Japan, Taiwan, South Korea) to cease improperly intervening in currency markets to gain competitive advantage. These countries run large trade surpluses with the United States and keep their exchange rates low, in part, to stay competitive with China. If China were to revalue its currency they too would likely adjust. The U.S. Treasury Department has repeatedly downplayed these problems in its semi-annual report on international exchange rate policies, resulting in the administration's taking inadequate action against currency manipulation.
- China is continuing to attract massive levels of foreign direct investment (FDI), including \$57 billion in 2003. Its policies to attract FDI have been supplemented by industrial policies aimed at developing national productive capacity in selected "pillar" industries. These policies support Chinese corporations through a wide range of measures that include tariffs, limitations on access to domestic marketing channels, requirements for technology transfer, government selection of partners for major international joint ventures, preferential loans from state banks, subsidized credit, privileged access to listings on national and international stock markets, discriminatory tax relief, privileged access to land, and direct support for R&D from the government budget. Such policies give Chinese industry an unfair competitive advantage, thereby contributing to erosion of the U.S. manufacturing base. Many of these policies are not permitted under World Trade Organization (WTO) and U.S. trade rules.
- The textile and apparel industries have suffered enormous trade-related job losses. Employment in textile mills, textile product mills, and apparel has fallen by nearly half over the last decade. The ending of the Multifiber Arrangement (MFA) at the end of 2004 promises to significantly increase U.S. imports of Chinese textile and apparel products and wreak further heavy job loss on these sectors.

- More generally, the problems afflicting U.S.-China economic relations epitomize many of the economic problems surrounding globalization. These include loss of manufacturing jobs, outsourcing of service sector jobs, and international wage competition, all of which put downward pressure on the wages of many U.S. workers. Policymakers need to address the systematic competitive pressures and dislocations that China's policies and practices exert on U.S. labor markets.

OVERVIEW

The overvaluation of the dollar against the world's currencies has been a major contributing factor in the worsening of the U.S. trade deficit over the last several years. Of particular concern is the undervaluation of the yuan against the dollar. China pegs its currency to the dollar, and the yuan has traded at 8.28 per dollar since 1998. During this period, China has experienced massive export sector productivity growth driven by FDI. This situation has enormously strengthened China's competitive advantage, rendering the yuan undervalued. In a free market, China's productivity growth, trade surplus, and inflows of FDI would have caused significant exchange rate appreciation. However, China systematically intervenes in the currency market to prevent this from happening, thereby maintaining an important competitive advantage for Chinese exports.

During the past year, the Commission held several hearings analyzing the impact of U.S.-China trade and investment on the U.S. economy and particularly on the U.S. manufacturing base. The Commission held a hearing on September 25, 2003, in Washington, DC, where testimony was presented by members of the House and the Senate, economists, experts on China's economic development, and representatives of U.S. manufacturing and labor organizations. This hearing focused on (1) China's exchange rate policy and its impact on the U.S.-China trade deficit and U.S. manufacturing activity, and (2) China's investment strategies aimed at attracting FDI.

A field hearing was held on January 30, 2004, in Columbia, South Carolina. It focused on China's impact on the U.S. manufacturing base, with a special focus on China's impact on the textile, apparel, steel, and plastics industries. South Carolina suffered the largest percentage loss of jobs of any state between November 2002 and November 2003, and Columbia suffered the largest percentage loss of jobs for any metropolitan area in the United States.³ The hearing included a panel on the community effects of a declining manufacturing base. These impacts include loss of local tax bases needed for funding education and essential services. The Commission heard testimony from local political leaders, civic leaders, and business and labor leaders.

The Commission also held a field hearing on *China as an Emerging Regional and Technology Power: Implications for U.S. Economic and Security Interests* in San Diego, California on February 12-13, 2004. This hearing focused on China's high-tech development strategy, China's role in the global supply chain, and the implications for U.S. technological leadership.

ANALYSIS AND FINDINGS

The Imbalanced U.S.-China Trade Relationship and Its Impact on U.S. Manufacturing

The dominant feature of U.S.-China economic relations in 2003 was the goods trade deficit. This widened from \$103 billion in 2002 to \$124 billion in 2003, a 20.3 percent increase. The trade deficit with China has now grown at an average rate of 21 percent for the last thirteen years, rising from \$10.4 billion in 1990 to \$124 billion in 2003.

This expansion of the U.S. trade deficit with China occurred in tandem with a worsening of the overall U.S. goods trade deficit. Between 1997 and 2003, the total U.S. goods trade deficit rose from \$180.5 billion to \$535.5 billion. However, though part of an overall trade deficit problem, there are several features of the China trade deficit that stand out and mark it as qualitatively different and more problematic:

- The China deficit represents 23.2 percent of the overall U.S. goods trade deficit (see figure 1.1 at the end of this chapter). This compares with Japan, which represents 12.3 percent of the deficit, and the eleven countries of the euro area, which represent 14.1 percent.
- In 2003, the total U.S. goods trade deficit rose by \$67.2 billion to \$535.5 billion, and China accounted for 31.3 percent of the increase. If the U.S.-China goods trade deficit continues to grow over the next five years at an average annual rate of twenty-one percent—as it has since 1990—it will rise to \$321 billion in 2008.
- Since 1988, the goods trade deficit with China has grown from \$2.8 billion to \$124 billion, while the total U.S. goods trade deficit rose from \$118.5 billion to \$535.5 billion. The deficit with China has therefore become a larger share of the total deficit. Figure 1.2 shows the increasing U.S.-China goods trade deficit and the increasing Chinese share of the total U.S. goods trade deficit. This pattern has two serious implications. First, China is contributing to a higher overall deficit, which costs the United States significant numbers of jobs and reduces economic growth. Second, China is displacing exports from other developing countries, causing problems in those countries.
- The U.S.-China trade deficit represents the United States' most lopsided major manufacturing trade relationship. This can be seen from the country import-export ratios shown in figure 1.3, which show that Chinese imports into the United States are over five times larger than U.S. exports to China. For other major manufacturing trading partners, the ratios are much lower, indicating a better balance between imports and exports.
- U.S.-China trade also raises strategic technology concerns. China is now the largest supplier of advanced technology products (ATP) imports (\$29.3 billion in 2003) to the United States, and the U.S. ATP deficit with China is also the largest (\$21.0 billion in 2003). Since 1998, the United States has moved from a global ATP trade surplus of \$29.9 billion to a global ATP deficit of \$27.4 billion in 2003. Figure 1.4 shows the evolution of the U.S. global ATP trade balance and the ATP trade balance with China. The

ATP trade deficit with China now accounts for seventy-seven percent of the global ATP deficit.⁴

- China has taken inadequate steps to correct the imbalanced trade relationship with the United States, including taking no action to revalue its fixed exchange rate. This contrasts with Canada and the euro area countries. This group had a combined goods trade surplus with the United States of \$195.8 billion, but their currencies have appreciated significantly against the dollar (see figure 1.5). This stands to reduce future trade deficits by making their products more expensive and U.S. products cheaper. The euro has appreciated by almost thirty-five percent since January 2, 2002.⁵

The expansion of the total U.S. trade deficit and the U.S. trade deficit with China has occurred against a troubling background of “jobless” recovery and continued loss of U.S. manufacturing jobs. Though 2003 was a year of recovery marked by significant GDP growth, the U.S. economy ended it with sixty-one thousand fewer jobs than in December 2002.⁶ Especially troubling was the continued loss of jobs in manufacturing, the sector that is most impacted by international trade. Over the course of 2003, manufacturing lost a further 575,000 jobs, ending the year with total employment of 14,324,000. The lion’s share of these losses was in durable manufacturing, which lost 363,000 jobs and employment fell to 10,044,000. Manufacturing employment contracted for forty-three consecutive months between July 2000 and February 2004—an unprecedented event. During this period, total manufacturing employment fell from 17.3 million to 14.3 million.

The worsening of the trade deficit, the jobless recovery, and the decline in manufacturing employment are interconnected. The decline in manufacturing employment during the early stages of economic recovery appears to be linked to the new phenomenon of “jobless” recovery. The first jobless recovery occurred in 1991–92, while the second jobless recovery has been in place since 2001. This pattern of jobless recovery from recession marks a break from business cycle recoveries prior to 1991. A salient feature of these two jobless recoveries is the failure of manufacturing employment to rebound. This is shown in figure 1.6, which presents the percentage increase in private employment and manufacturing employment two years into economic recovery for nine business cycles since 1945.⁷ In the seven recoveries from 1949 to 1990, manufacturing employment grew robustly as the economy entered the recovery stage. However, in the two recoveries since, manufacturing employment has fallen for a long while into the recovery. In the first jobless recovery, which began in March 1991, manufacturing employment continued falling through October 1992. In the current jobless recovery, which began in November 2001, manufacturing employment continued falling through February 2004. It has expanded in March and April of 2004, but it is still too early to judge the strength of this employment recovery. The uncertainty of this recovery is also indicated by average real hourly wages which fell slightly in the first quarter of 2004 and are essentially unchanged from the level prevailing in December 2001.⁸

The decline in manufacturing employment is in turn linked to the trade deficit. In 2003, the non-petroleum goods trade deficit

was \$415 billion, versus \$375 billion in 2002. This represents an increase of \$40 billion. Using an input-output methodology, the Economic Policy Institute (EPI) estimates that in 2000 every \$1 billion of imports into the United States embodied 9,500 jobs.⁹ Applying this jobs multiplier, the worsening of the goods trade deficit in 2003 cost 380,000 jobs.

A similar calculation can be applied to the China trade deficit, which jumped from \$103 billion in 2002 to \$124 billion in 2003. Using a job multiplier of 9,500 per billion dollars, the \$21 billion increase in the China deficit in 2003 implies a loss of 199,500 jobs. Since 1997, the China trade deficit has risen by \$74 billion to \$124 billion. Applying the job multiplier, this yields a total loss of 703,000 jobs.

Some argue that the loss of manufacturing jobs is unrelated to the trade deficit and is due to increased manufacturing productivity and a decline in consumption of manufactured goods. The Commission disagrees with this argument. A recent EPI study shows that consumption of manufacturing goods as a share of total demand remains largely unchanged. And though rising productivity and the recession would have reduced manufacturing employment, the trade deficit has also mattered. According to EPI, the increase in the manufactured goods trade deficit accounts for 58 percent of manufacturing job loss between 1998 and 2003 and 34 percent of the loss between 2000 and 2003.¹⁰

The Importance of Manufacturing

Trade deficit-induced losses of manufacturing jobs represent a major economic and national security concern. As noted by Commerce Secretary Don Evans, “The President believes that our economic and national security require a stable, robust manufacturing sector that produces sophisticated and strategically significant goods, here in the United States.”¹¹

The manufacturing sector is a major engine of economic growth for the U.S. economy. Two-thirds of R&D spending and more than ninety percent of new patents derive from the manufacturing sector.¹² Productivity growth in the U.S. economy has increased during the last decade, but the increase has been largest in the manufacturing sector, where the rate of increase is twice the rate of the overall economy. Manufacturing is also critical to America’s high standard of living, as it is through manufacturing that America pays its way in the world economy. Manufacturing accounts for over eighty percent of U.S. exports of goods, and it accounts for two-thirds of total exports.¹³

A recent study by the National Association of Manufacturing’s Council of Manufacturing Associations, *Securing America’s Future: The Case for a Strong Manufacturing Base*, warns that “if the U.S. manufacturing base continues to shrink at the present rate and the critical mass is lost, the manufacturing innovation process will shift to other global centers. If this happens, a decline in U.S. living standards in the future is virtually assured.”¹⁴ Finally, not only does the loss of manufacturing pose a threat to future standards of living, but it also poses a threat today. Manufacturing jobs pay twenty percent more on average and provide better benefits.

Their disappearance therefore undermines the economic health of America's middle class.

The importance of manufacturing is captured in testimony before the Commission by Franklin J. Vargo, vice president for international economic affairs, National Association of Manufacturers:

(t)he United States economy would collapse without manufacturing, as would our national security and our role in the world. That is because manufacturing is really the foundation of our economy, both in terms of innovation and production and in terms of supporting the rest of the economy. For example, many individuals point out that only about three percent of the U.S. workforce is on the farm, but they manage to feed the nation and export to the rest of the world. But how did this agricultural productivity come to be? It is because of the tractors and combines and satellite systems and fertilizers and advanced seeds, etc., that came from the genius and productivity of the manufacturing sector.

Similarly, in services—can you envision an airline without airplanes? Fast food outlets without griddles and freezers? Insurance companies or banks without computers? Certainly not. The manufacturing industry is truly the innovation industry, without which the rest of the economy would not prosper.¹⁵

These views are shared by the AFL-CIO. In a report submitted as part of the testimony of Richard L. Trumka, secretary-treasurer of the AFL-CIO, before the Senate Committee on Banking, Housing, and Urban Affairs on "The Impact of the Exchange Rate on the United States Balance of Trade, Economic Growth and Employment" held on May 1, 2002, the AFL-CIO states:

Loss of manufacturing jobs carries a high cost. Manufacturing is widely recognized as a principal engine of productivity growth, and there is evidence of positive productivity spill-overs from manufacturing to non-manufacturing. There is also emerging evidence that some of the greatest gains from new economy information technologies may come from application of these technologies to manufacturing. Shrinking the manufacturing sector results in a smaller base on which to build productivity growth and on which to apply the new information technologies. Consequently, the U.S. stands to have slower future productivity growth, which will result in a lower future standard of living.¹⁶

Trade Dislocations and the Impact on Communities

The loss of manufacturing jobs caused by the U.S. trade deficit has profound implications for many communities. At its Columbia, South Carolina, hearing, the Commission listened to powerful testimony on the extent to which trade-related economic dislocations have impacted many South Carolina manufacturing communities. The Commission was told that the significant loss of jobs in South Carolina due to import competition and off-shoring had resulted in the erosion of the local tax base in many communities. Tax base

erosion then contributes to declining law enforcement and infrastructure investment, and declines in the provision of health services, all of which have a debilitating impact on families and quality of life.

As engagement with the global economy grows, it is likely that there will continue to be significant job losses as a result of outsourcing and changing patterns of production. Such job losses often impose large costs on those whose jobs are outsourced. Given that job loss stands to be a permanent feature of the economic landscape, the Commission believes there is a need for new policies to help displaced workers.

Measuring the U.S.-China Trade Deficit

Official U.S. data show a large and growing U.S. trade deficit with China. Official Chinese data show a significantly smaller Chinese trade surplus with United States. According to U.S. data, the deficit was \$124 billion in 2003, whereas Chinese data report it as \$58.6 billion.¹⁷ This discrepancy has led to claims by the Chinese government that the U.S.-China trade deficit is overstated. However, there are serious concerns about the veracity and reliability of Chinese data.

One reason for the discrepancy is the U.S. practice of treating Chinese exports to Hong Kong that are reexported to the United States as Chinese product, whereas China argues these goods should be counted as an import from Hong Kong. Chinese officials have also argued that U.S. imports from China routed through Hong Kong are overstated because they include value added in Hong Kong.

The Chinese government's approach to counting U.S.-China trade is subject to serious methodological difficulties associated with the problem of "transfer pricing." For the methodology to work, it is vital that goods imported into Hong Kong and reexported to the United States be counted at their proper market value. The current U.S. approach to measuring bilateral trade is not afflicted by this problem and for this reason is superior.

An alternative way of getting an overall picture of U.S. trade with China is to include both China and Hong Kong. According to U.S. data, in 2003 Hong Kong had a trade surplus with the United States of \$4.7 billion. Adding this to the \$124 billion China deficit figure makes for an adjusted China deficit of \$119.3 billion, which is still double the official Chinese estimate of \$58.6 billion.

To address these differences, U.S. and Chinese trade officials recently agreed to establish a new working group to try and bridge the gap between how each country measures bilateral trade.¹⁸ Improved data collection is always welcome. However, the Commission is concerned that these efforts not be used by the administration or Chinese government as a way of diminishing the China trade deficit so as to reduce the salience of the problem.

China's Exchange Rate Policies and the Impact on the U.S. Economy

Effect of Misaligned Currencies

International trade is dominated by manufacturing trade, and overvaluation of the dollar has significantly reduced the inter-

national competitiveness of U.S. manufacturing industry. This lack of competitiveness is reflected in the growing U.S. trade deficit, which has negatively impacted manufacturing output and employment. The negative effects of the overvalued dollar on manufacturing operate through several channels.¹⁹ First, overvaluation makes exports relatively more expensive, reducing foreign country demand for U.S. manufactured goods. Second, overvaluation makes imports cheaper, inducing a substitution in spending away from domestically produced manufactured goods to foreign-produced goods. Third, overvaluation reduces the profitability of U.S. manufacturing firms by making foreign goods cheaper, and this reduces firms' incentive to invest in new production capacity. Fourth, by making U.S.-based production relatively more expensive, an overvalued dollar gives U.S. companies an incentive to shift production offshore and to build new production facilities offshore.

These negative effects on the trade deficit and manufacturing in turn adversely impact overall U.S. economic growth. According to the Bureau of Economic Analysis, the U.S. goods trade deficit lowered GDP growth by 0.09 percent in 2001, 0.71 percent in 2002, and 0.42 percent in 2003. The trade deficit therefore deepened the recession and is hampering the recovery.²⁰

The critical economic significance of exchange rates was summarized in the testimony before the Commission of Franklin J. Vargo; "Only 11 percent of the cost of a U.S. manufactured good is labor. ... If a product gets a twenty or forty percent price advantage because of a currency, that is a much more significant factor."²¹

The reason is that currency misalignments work on the entire cost base, so that an overvalued currency raises the entire cost structure.

Agriculture and the Dollar

Agriculture is also affected by exchange rates.²² Approximately twenty percent of U.S. agricultural production is exported to other countries, and agricultural products are commodities.²³ This means competitiveness is crucial, and competitiveness is significantly affected by the exchange rate. The overvaluation of the dollar against most of the world's currencies, combined with the fact that China pegs its currency to the dollar, has meant that U.S. agricultural exports have been rendered less competitive in the China market. This has reduced the benefits to U.S. agriculture of China's entry into the WTO.

An upward revaluation of the yuan against the dollar will make U.S. agricultural products cheaper in Chinese currency terms, thereby increasing Chinese demand for U.S. agricultural exports.

Remedying the Overvalued Dollar and Undervalued Yuan

There is widespread agreement that the dollar has been overvalued against the currencies of the world's major trading countries.²⁴ With regard to China, the Commission heard testimony that the yuan is undervalued by between fifteen and forty percent.²⁵ Based on this testimony and other economic evidence, the Commission believes that

- the yuan needs to be revalued substantially upward against the dollar;

- As part of this revaluation, the yuan should be pegged against a trade-weighted basket of currencies to avoid excessive fluctuation against the currency of any single country;
- China should refrain from adopting a floating exchange rate at this time, as its banking system and financial markets are not yet prepared for such an arrangement; and
- China should take active steps to reform its banking system and financial markets to prepare them for an eventual floating exchange rate.

The Case for Revaluing the Yuan

The dollar has now entered a period of correction against the currencies of other industrialized countries. As shown in figure 1.5, since January 2, 2002, it has fallen 33.3 percent against the euro, 16.4 percent against the yen, and 14.4 percent against the Canadian dollar. In addition, it has also fallen significantly against other currencies such as the pound sterling and the Australian dollar. However, there has been no adjustment against the Chinese yuan, which is fixed through official intervention. Additionally, there has been little in the way of correction against the Taiwanese, South Korean, and Singaporean currencies, all of which countries run large trade surpluses with the United States.

This lack of adjustment has occurred despite the fact that there is compelling evidence that the yuan is undervalued. China now constitutes the single largest contributor to the U.S. trade deficit, and economic fundamentals support the claim that the yuan is undervalued. China's economy has been characterized by a trade surplus (external imbalance) and by rapid economic growth with incipient inflation (internal imbalance).²⁶ A currency revaluation will help restore both trade balance and domestic economic balance by reducing exports and reducing demand for domestically produced goods. Conversely, the U.S. economy has a large trade deficit (external imbalance) and excess capacity and unemployment (domestic imbalance). Dollar devaluation will help restore both external and internal balance by increasing exports and demand for U.S.-produced goods.

A revaluation of the yuan is also needed for global economic equilibrium. As noted above, the United States has significant trade deficits with other East Asian economies, including Taiwan and South Korea. These economies are apprehensive about revaluing their currencies for fear that they will lose competitiveness relative to China. A revaluation of the yuan would likely free this logjam, allowing these economies to revalue too, thereby smoothing and accelerating the process of dollar adjustment.

Indirectly, however, China has an additional impact because Japan, South Korea, Taiwan, and others throughout Asia claim they have to intervene and keep their currencies undervalued because of the very low manipulated Chinese rate. In other words, they say they have to manipulate their currencies to remain competitive with China. There is also good reason to believe that if China were to substantially revalue its currency, the other Asians could be persuaded to scale back their Central Bank purchases and allow their currencies to float upward.²⁷

Additionally, failure to revalue China's currency while currencies of other major trading partners appreciate promises to cause economic disruption. This is because other economies—such as Japan and the euro area—are implicitly being forced to take on a larger burden of adjustment to correct the U.S. trade deficit, while the country with the largest surplus (China) undertakes no adjustment.

Arguments Against Revaluing the Yuan Do Not Hold

Some argue that the yuan does not need to be revalued. The Commission rejects this position.

- (1) One argument is that revaluing the yuan could lead to a financial crisis in the Chinese banking system that ends up perversely generating a lower value of the yuan. The claim is that opening China's capital account and floating the yuan risks a massive exodus of Chinese savings that could trigger a domestic financial crisis and yuan depreciation. Thus, paradoxically, capital account liberalization and yuan floating could actually cause depreciation rather than appreciation.

However, this argument confuses revaluation of China's exchange rate with a shift to a floating exchange rate. The Commission does not recommend floating the yuan at this time. Instead, China should significantly revalue the yuan upward while maintaining capital controls and a fixed exchange rate over the near term. This would address the underlying balance of payments disequilibrium problem while avoiding financial crisis. China has begun to recognize its problem of domestic financial fragility but must now accelerate the process of remedying it. The fact that capital account opening could trigger a massive outflow of Chinese bank deposits reveals the inhospitable climate of Chinese financial markets for domestic wealth owners. China must therefore move to make its financial assets more attractive. The threat of domestic capital flight is not going to disappear. Indeed, it stands to grow in magnitude as Chinese household financial wealth grows with development and households in turn seek to diversify their portfolios internationally. China must therefore begin enacting measures that make domestic financial assets more attractive. These measures should include corporate and market governance reforms and issuance of an increased supply of attractive domestic financial assets. The bottom line is that China's domestic financial fragility does not justify an undervalued exchange rate that exports deflationary pressures and destroys U.S. manufacturing jobs.

- (2) A second argument is that there is no need to revalue, since market forces will force a revaluation despite the Chinese government's exchange rate intervention. This argument is based on the discredited economic doctrine of monetarism. The claim is that China's persistent trade surplus forces its central bank to sell yuan and buy dollars to prevent appreciation and that this expands the money supply, which will in turn cause inflation that drives up Chinese prices. As a result, China will gradually become less competitive, while U.S. manufacturing companies will become more competitive.

The above monetarist argument is flawed. First, even if the mechanism worked, there are long and unpredictable lags between expansion of the money supply and higher prices. In the meantime, American manufacturing firms may be compelled to close down, with consequent loss of jobs. Second, Chinese monetary authorities can take measures to mitigate the effect of a rising money supply on prices. These include raising reserve requirements in the banking system and sterilizing the monetary expansion by selling bonds and thereby withdrawing money from circulation.

- (3) A third argument is that the China trade deficit is unrelated to the exchange rate and is the result of a shortage of U.S. saving—principally the result of the large U.S. government budget deficit. The argument is that the U.S. economy is consuming in excess of what it can produce and has to import the balance.

The Commission believes that the United States must address its chronic budget deficits, but it rejects the notion that this obviates the need for China to address its currency undervaluation. Contrary to the claims of the saving shortage hypothesis, the U.S. economy currently has severe excess manufacturing capacity and is capable of producing significantly increased manufacturing output. A shortage of national savings is not the problem. The real problem is that the misaligned exchange rate results in U.S. goods being too expensive relative to foreign goods. This drives down demand for U.S.-produced output, and, over a more extended time period, contributes to the elimination of U.S. manufacturing capacity and the creation of a structural trade deficit. Plant closures and the loss of well-paying jobs in turn undermine the tax base and contribute to state and local fiscal problems.

- (4) A fourth argument is that though the United States has a large trade deficit with China, China's overall trade surplus with the rest of the world has been much smaller, and in the first quarter of 2004 it registered a small deficit. Consequently, China's currency may not be undervalued.

Again, the Commission rejects this argument. Figure 1.1 shows that the United States has a trade deficit with every region of the world, and the deficit with China is especially large. This pattern points to a need for a generalized realignment of the dollar, and China should revalue its currency as part of that realignment. Second, for the last several years, China has run a global trade surplus. Moreover, the fact that China has run a surplus even as it grew at nine percent per annum is compelling evidence of undervaluation. Any other country that grew at that rate would have quickly run up a huge trade deficit. The small move into deficit in the first quarter of 2004 reflects continuing breakneck growth and rising commodity prices, particularly in oil. That China still essentially has balanced trade under these conditions is testimony to how undervalued the yuan is. Finally, China is also running a capital account surplus generated by the flood of FDI into China. This means China has an enormous basic balance surplus, defined as the combined surplus on current and capital accounts. Thus, in 2003, China had a current account surplus of \$45.9 billion and a

capital account surplus of \$52.7 billion, making for a basic balance of \$98.6 billion.²⁸ This put significant upward pressure on the exchange rate, but purchases of \$116.8 billion of foreign exchange by China's central bank prevented the exchange rate from appreciating.²⁹

Prohibitions on Currency Manipulation³⁰

By manipulating its currency to keep it artificially low, China effectively gives its exporters an exchange rate subsidy. Such currency manipulation, as discussed below, is illegal under the terms of both China's International Monetary Fund (IMF) and WTO membership. In addition, U.S. trade law also has provisions to address currency manipulation by countries.

With regard to U.S. law, section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the Treasury Department to analyze the exchange rate policies of foreign countries, in consultation with the IMF, and to consider whether any countries are manipulating the rate of exchange between their currency and the dollar for purposes of preventing effective balance of payments adjustments or gaining an unfair advantage in international trade. The Treasury is required to report to the Senate Banking Committee twice each year with an assessment of currency manipulation by trading partners. The Secretary of the Treasury is required to undertake negotiations with those countries found to be manipulating their currencies if they are also running a material global current account surplus and a significant bilateral surplus with the United States, unless such negotiations would have a serious detrimental impact on vital national economic and security interests. In its latest report on currency manipulation (April 2004) the Treasury again found that "no major trading partner of the United States met the technical requirements for designation under the Omnibus Trade and Competitiveness Act of 1988."³¹ In arriving at this finding, the Treasury gives no indication as to what these technicalities are, and the finding of no manipulation is hard to comprehend in light of the IMF's definition of manipulation as "protracted large scale intervention in one direction in the exchange market."

Currency manipulation is inconsistent with membership in both the IMF and the WTO. Article IV, section 1, of the IMF's Articles of Agreement requires members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The IMF surveillance provision related to article IV defines currency manipulation as "protracted large scale intervention in one direction in the exchange market." The WTO rules derive from the General Agreement on Tariffs and Trade's (GATT) article XV dealing with exchange rate arrangements, which stipulates that members should not take exchange rate actions that "frustrate the intent of the provisions of this agreement." The intent of the agreement is stated in the preamble, which declares the objective to be "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade." Moreover, there is a direct linkage between GATT article XV and IMF article IV, since the GATT's "frustrate the intent" test is to be resolved

through full consultation with the IMF, and members are instructed to “accept all findings of statistical fact presented by the Fund relating to foreign exchange.”

Under IMF and WTO rules, countries are allowed to maintain fixed exchange rates. However, exchange rate parities should be fixed at a level consistent with market equilibrium so that buying and selling pressures should largely balance out. If the exchange rate is set too low, there will be need for protracted, large-scale, one-way market intervention to prevent appreciation. This is the IMF’s definition of currency manipulation, and it is how a country maintains an undervalued currency in order to gain competitive advantage.

The evidence shows that there can be little doubt that China has been engaged in extensive, “protracted large-scale intervention in one direction.” Such intervention has China’s central bank buying dollars in exchange for yuan deposits in the Chinese banking system. Between December 2000 and December 2003, foreign exchange holdings of China’s central bank more than doubled from \$166 billion to \$403 billion. Figure 1.7 reports annual official purchases of foreign exchange by China, Japan, Taiwan, and South Korea, and it shows a strong upward trend. In 2001, Chinese official purchases were \$46.6 billion. In 2002, official purchases were \$74.2 billion, and in 2003 they were \$116.8 billion.

Not only has China’s central bank been intervening to hold down the value of its currency but so too have several other East Asian countries. The Bank of Japan’s annual official purchases of foreign exchange rose from \$40.5 billion in 2001 to \$201.3 billion in 2003. Over the period December 2000–December 2003, Japan engaged in even more extensive official intervention and accumulated even more dollar reserves than China. And in January 2004, the Bank of Japan bought a staggering \$68.2 billion dollars in just one month. Taiwan has also engaged in persistent protracted official intervention, and in 2003 its holdings of reserves rose by \$45 billion to \$206 billion. A similar story of persistent intervention can be told for South Korea, and in all cases the problem has worsened over the course of 2003. These developments reveal a systemic exchange rate problem, with the United States’ major trading partners in East Asia gaming the system to gain competitive advantage. These practices call for a firm and credible response on the part of the U.S. government that applies to all countries that improperly intervene to hold down currency values.

There is reason to believe that the currency interventions of East Asian countries are closely linked to China’s intervention. All fear the economic dislocation that could result from loss of competitive advantage to China, and hence their parallel intervention. The implication is that if China were to revalue upward, other East Asian countries would cease intervening and let their currency values move upward.

Financial Markets, U.S. Interest Rates, and China’s Exchange Rate Policy

A final point concerns the implications for U.S. financial markets and interest rates of China’s exchange rate policy. For the last several years, China has run large trade surpluses with the United

States. To prevent the yuan from appreciating against the dollar, China has purchased dollars in the foreign exchange market and then recycled these purchases into U.S. financial assets. As a result, China's foreign reserves, which are largely made up of short-term U.S. government liabilities, stood at \$420.4 billion at the end of November 2003.³²

The accumulation of these holdings has strengthened the demand for U.S. government bonds, which has raised their price and lowered their interest rate. Consequently, some fear that if China ceases to intervene in the currency market, this will lower bond prices and drive up interest rates.

This fear is misplaced. First, if China were to cease intervening, the effect on the overall short-term U.S. government bond market would be relatively small given the size of the market. Second, China has been accumulating short-term bills and bonds, and the Federal Reserve can step in if it chooses to and make up for any decline in Chinese purchases.

Whereas ending Chinese currency intervention would have negligible effects on interest rates, a more serious threat comes from the possibility that the People's Bank of China might choose to re-allocate its existing portfolio holdings and shift out of U.S. bonds. If this shift were large and sudden, it could cause a spike in U.S. interest rates. Moreover, given the use of derivative contracts and other exotic risk sharing and speculative financial instruments, such a spike could potentially trigger financial turmoil. This is a dangerous economic vulnerability for the United States, and it highlights how sustained trade deficits confer economic leverage on other countries.

China's Industrial and Investment Policies

China's surging exports and trade surplus are based on its rapidly rising industrial capacity. This capacity is in turn built on massive FDI. In 2002, China received \$52.7 billion of FDI, and it surpassed the United States as the world's largest recipient of FDI in that year.³³ In 2003, the inflow of FDI was \$57 billion, and the total stock of FDI in China now exceeds \$400 billion.³⁴ With inflows anticipated to continue at this level, China will soon be the second largest holder of FDI in the world, after the United States.

The impulse behind the flood of FDI into China is the view held by global corporations that China is central to long-term strategy. Many companies view China as a production platform for exporting to the rest of the world, and they also see China's potentially massive internal market as providing profitable future opportunities. The attractiveness of China as a site for FDI rests on several factors, one of which is the abundance of cheap labor. However, China's mercantilist trade policies and poor labor and environmental policies also play an important role. Thus, the following holds true:

- The maintenance of an undervalued exchange rate keeps production costs low, measured in foreign currency terms. This makes it attractive for global companies to locate export production facilities in China.
- Failure to enforce internationally recognized labor and environmental standards is another source of competitive advantage that is used to attract investment. Just as an undervalued ex-

change rate can lower domestic production costs, so too can a repressive labor system such as China's. That system denies workers' rights of freedom of association and collective bargaining, and it enforces a system of work permits that discriminates against rural workers.

- Policies to attract FDI have been supplemented by industrial policy aimed at developing national productive capacity in selected "pillar" industries. This policy supports Chinese corporations through a wide range of measures that include tariffs, limitations on access to domestic marketing channels, requirements for technology transfer, government selection of partners for major international joint ventures, preferential loans from state banks, subsidized credit, privileged access to listings on national and international stock markets, tax relief, privileged access to land, and direct support for R&D from the government budget.³⁵

China's buildup of national and multinational productive capacity raises many concerns. Its rapid increase in export capacity could lead to even larger future U.S.-China trade deficits, making it critical that China be obliged to live up to its WTO obligations and play by the rules of the game. At the sectoral level, the rapid buildup of steel-producing capacity, on the basis of subsidized finance, poses a threat of massive excess capacity in the event of a slowdown in the Chinese economy, which could then be dumped onto the global market.

In the textile and apparel sectors, the imminent end of the Multifiber Arrangement (MFA) on January 1, 2005, risks destroying the remaining U.S. textile and apparel industry, which still employs 713,000 people.³⁶ According to the American Textile Manufacturers Institute, Chinese apparel imports took fifty-three percent of the U.S. market in June 2003, and this share is projected to rise to seventy-five percent in 2004. Moreover, Mexico and the nations of Central America and the Caribbean are projected to lose one million textile and apparel jobs following the removal of MFA quotas, creating great economic distress and possible social and political unrest.³⁷ Other major textile-producing nations, such as Bangladesh and Sri Lanka also stand to be affected. Similarly, the economic development benefits of the Africa Growth and Opportunity Act stand to be significantly diminished. This outlook is corroborated by a recent study by McKinsey & Company that predicts that China could account for half of the world's clothing and textile exports by 2008, up from 21.6 percent in 2000.³⁸ These concerns have prompted textile organizations from thirty-one countries to sign the Istanbul Declaration, which requests the WTO to extend the MFA.³⁹

The U.S. auto and auto parts industries represent another sector threatened by China's FDI policies. China now intends to speed up efforts to boost automobile and component exports, according to a senior Chinese trade official. Vice-Minister of Commerce, Wei Jianguo, recently stated that the Chinese government has set an export target of U.S. \$70 billion to U.S. \$100 billion a year by 2010.⁴⁰ The goal is to make China the component supply center for international auto manufacturers. The government plans to take an active role in boosting production by encouraging FDI and encouraging mergers and acquisitions. Auto parts production will

stimulate vehicle assembly, while vehicle assembly will stimulate parts production.

Finally, the high-technology sector also faces competitive threats from China. Here, Chinese industrial policy is based on the use of government procurement and of proprietary domestic technology standards. Such standards are put in place as a way of compelling technology sharing and as a way of compelling foreign companies to produce in China if they wish to sell in the Chinese market. This issue is more fully explored in Chapter 7.

China's Economy: What if the Boom Busts?

China has enjoyed an economic boom for the past three years, with annual GDP growth steadily accelerating from 7.3 percent in 2001 to 9.1 percent in 2003. Now, there are fears that China's growth may be unsustainable and may even have elements of a bubble. A particular cause of concern has been a rise in consumer inflation, which rose from negative 0.6 percent in 2002 to 1.2 percent in 2003 and is expected to rise further to three percent in 2004.⁴¹

China's strong growth performance has been driven by two factors. First, there has been a rapid expansion of domestic credit, driven by lending by state-owned banks. In 2003 and the first quarter of 2004, total bank lending rose at an annual rate in excess of twenty percent.⁴² Second, there has been rapid export growth, driven by exports of multinational companies located in China. In 2003, total Chinese exports grew by 34.6 percent, and the multinational share of these exports rose to fifty-five percent.⁴³ The fact that their share increased indicates that export sales of these companies are rising faster than overall Chinese exports.

In light of fears of accelerating inflation and a possible investment bubble, China's economic authorities have recently moved to slow growth by seeking to check the rate of credit expansion. Slowing an economic boom is a difficult task under any circumstances, but China faces special challenges owing to its suspect credit allocation system.

The core problem concerns lending by China's state-owned banks, much of whose lending is driven by political and noncommercial considerations, some with no expectation of repayment. This has two significant negative consequences. First, it means that many loans are likely to end up as nonperforming, which threatens to undermine further the stability of China's banking system. Second, with loans directed on the basis of political and noncommercial criteria, this finance has sometimes been used to accumulate capacity in sectors already in overcapacity. Consequently, there will continue to be inflationary pressures in sectors short of capacity, while there may be deflationary pressures in sectors where unnecessary capacity has been accumulated.

These problems represent major failings of the Chinese development model. Rapid domestic credit expansion can make for strong aggregate demand growth, while multinational company production can generate exports earnings that provide an international financial cushion. However, ultimately, an economy must make productive investments that ensure capital is accumulated in those places

where it is needed and can pay for itself by earning a sufficient rate of return. This calls for market mechanisms.

If China has a significant economic slowdown, the U.S. economy may suffer some collateral damage (as detailed below). Policy-makers should be aware of this possibility, but they should also recognize that this damage is likely to be limited. Moreover, concerns about the effects of a Chinese economic slowdown should not be used as reason to avoid addressing existing significant structural problems in the U.S.-China economic relationship.

- Many commodity-producing developing countries have benefited from higher commodity prices resulting from China's increased demand for resources. A Chinese economic slowdown will cause prices to fall back, thereby lowering the incomes of these producing countries and weakening their demand for U.S. exports. Additionally, many developing countries have borrowed on the back of higher commodity prices, and they may have problems meeting their financial commitments, which could then cause problems in global financial markets. Balanced against this, lowering global commodity and oil prices should lower U.S. inflation and benefit U.S. consumers.
- Given China's high rates of investment, funded by state bank lending, there is the prospect of significant surplus capacity in many Chinese industries. This surplus could find its way onto global markets, driving down prices and creating problems for companies in other countries. The steel industry is an instance where such a scenario could readily occur.
- The quantity of nonperforming loans (NPLs) in the Chinese banking sector could increase significantly. These loans should be a concern for equity market investors, particularly small investors whose retirement wealth is at risk. This is because China plans to sell shares in some of its major state-owned banks, and U.S. investors could significantly overpay by buying into these enterprises without full knowledge of the scale of the NPL problem.
- Finally, a slowdown of Chinese economic growth may be used to deflect attention away from China's undervalued currency. As discussed earlier in the chapter, China has a structural trade surplus with the United States that calls for a significant upward revaluation of the yuan. However, in the event of a domestic economic downturn, Chinese authorities may use the downturn to claim opportunistically that adjustment of the exchange rate is inappropriate, as it would compound the slowdown. In effect, China may try to use its internal economic imbalance to block adjustment of its external economic imbalance, with consequent continuing detrimental impact on U.S. manufacturing.

RECOMMENDATIONS

The Commission made additional recommendations on this topic in its transmittal letters to Congress forwarding the record of the Commission's hearings of September 25, 2003, and January 30, 2004, which are attached at appendix II.

Recommendations for Dealing with China's Currency Manipulation

- The 1988 Omnibus Trade and Competitiveness Act requires the Treasury Department to examine whether countries are manipulating their exchange rates for purposes of gaining international competitive advantage. The Treasury is to arrive at its finding in consultation with the IMF, which defines manipulation as “protracted large-scale intervention in one direction in the exchange market.” The Treasury has repeatedly evaded reporting on this test. The Commission recommends that Congress require the Treasury to explicitly address this test in its required report to Congress. Furthermore, a condition for taking action against a country that manipulates its currency is that an offending country be running a material global current account surplus in addition to a bilateral surplus. The Commission recommends that Congress amend this provision so that a material global current account surplus is not a required condition.
- The administration should use all appropriate and available tools at its disposal to address and correct the problem of currency manipulation by China and other East Asian countries. With regard to China, this means bringing about a substantial upward revaluation of the yuan against the dollar. Thereafter, the yuan should be pegged to a trade-weighted basket of currencies, and provisions should be established to guide future adjustments if needed. As part of this process, the Treasury Department should engage in meaningful bilateral negotiation with the Chinese government, and it should also engage in meaningful bilateral negotiations with Japan, Taiwan, and South Korea regarding ending their long-standing exchange rate manipulation. The administration should concurrently encourage our trading partners with similar interests to join in this effort. The Commission recommends that Congress pursue legislative measures that direct the administration to take action—through the WTO or otherwise—to combat China’s exchange rate practices in the event that no concrete progress is forthcoming.

Recommendations for Addressing China's Mercantilist Industrial and FDI Policies

- The Commission recommends that Congress direct the United States Trade Representative (USTR) and the Department of Commerce to undertake immediately a comprehensive investigation of China’s system of government subsidies for manufacturing, including tax incentives, preferential access to credit and capital from state-owned financial institutions, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, Chinese state-owned banks’ practice of noncommercial-based policy lending to state-owned and other enterprises, and China’s dual pricing system for coal and other energy sources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be

actionable subsidies under the WTO and lays out specific steps the U.S. government can take to address these practices.

- The Commission recommends that Congress direct the administration to undertake a comprehensive review and reformation of the government's trade enforcement infrastructure in light of the limited efforts that have been directed at enforcing our trade laws. Such a review should include consideration of a proposal by Senator Ernest Hollings (D-SC) to establish an assistant attorney general for international trade enforcement in the Department of Justice to enhance our capacity to enforce our trade laws. Moreover, the U.S. government needs to place an emphasis on enforcement of international labor standards and appropriate environmental standards.
- The Commission recommends that Congress direct the administration to work with other interested WTO members to convene an emergency session of the WTO governing body to extend the MFA at least through 2008 to provide additional time for impacted industries to adjust to surges in imports from China.

ENDNOTES

1. The figure of \$535.5 billion is based on customs data collected by the Foreign Trade Division of the U.S. Census Bureau. For national income accounts purposes, these data are adjusted for certain transactions, and the deficit in 2003 came to \$549.1 billion. Source: *U.S. International Trade in Goods and Services January 2004* (U.S. Department of Commerce, March 2004).

2. Commission's calculation using data from the U.S. Census Bureau and U.S.-China Business Council.

3. Dr. Charles W. McMillion, briefing paper prepared for The U.S.-China Economic and Security Review Commission, January 30, 2004, p. 2.

4. Sources: Ernest H. Preeg, *The Growing U.S. Trade Deficit in Advanced Technology Products (ATP)* (Arlington, VA: Manufacturers Alliance/MAPI, March 2004), and data provided by Charles McMillion, MBG Information Services, Washington, DC.

5. The euro closed at 0.89 per dollar on December 31, 2001. Source: Board of Governors of the Federal Reserve, <http://www.federalreserve.gov/releases/h10/hist/>.

6. In December 2002, total employment was 130,096,000. In December 2003, it was 130,035,000. Source: Bureau of Labor Statistics, <http://stats.bls.gov/ces/cesbtabs.htm>.

7. The brief cyclical recovery that began in July 1980 is excluded, as it lasted just twelve months and is not representative of a full cycle.

8. Source: Bureau of Labor Statistics, <http://data.bls.gov/sevlet/surveyoutputservlet>.

9. Based on unpublished data from the Economic Policy Institute, as summarized in Robert E. Scott, "China and the States: Booming Trade Deficit with China will Accelerate Job Destruction in Next Decade with Losses in Every State," issue brief (Washington, DC: Economic Policy Institute, May 2000).

10. J. Bivens, "Shifting Blame For Manufacturing Job Loss" (briefing paper, Washington, DC: Economic Policy Institute, 2004), p. 2.

11. Remarks at the Detroit Economic Club, September 15, 2003, http://www.commerce.gov/opa/speeches/Evans/2003/Sept_15_Evans_manufacturing_Detroit.htm.

12. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment and Exchange Rate Policies: Impact on the United States*, testimony of Ernest H. Preeg, "Chinese Currency Manipulation and the U.S. Trade Deficit," September 25, 2003, p. 74.

13. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, testimony of Franklin J. Vargo on behalf of the National Association of Manufacturers, September 25, 2003, p. 178.

14. The study was prepared by Dr. Joel Popkin, former Council of Economic Advisors member, and is referred to in the testimony of Franklin J. Vargo. See record of the Commission's hearing held September 25, 2003, p. 178.

15. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 178.

16. *The Overvalued Dollar and the Danger to Economic Recovery*, a report submitted as part of the testimony of Richard L. Trumka, secretary-treasurer, AFL-CIO, before the Senate Committee on Banking, Housing, and Urban Affairs, May 1, 2002.

17. "Wu Says U.S., China Agree to Dialogue on Measuring the U.S. Trade Deficit," *Inside U.S.-China Trade*, vol. 4, no. 17 (April 28, 2004): p. 6.

18. "Wu Says U.S., China Agree," p. 1.

19. These effects are documented in R.A. Blecker, "Exchange Rates in North America: Effects of the Over-valued Dollar on Domestic U.S. Manufacturing and Implications for Canada and Mexico," paper presented for the conference "Can Canada and Its NAFTA Partners Conduct Independent Macroeconomic Policies in a Globalized World?" (Ottawa, Canada: University of Ottawa, September 20-21, 2002), and "Overvalued Dollar Puts Hundreds of Thousands Out of Work," (Washington, DC: National Association of Manufacturers, March 2002).

20. Based on figures in figure 1.2 of the Bureau of Economic Analysis's "Gross Domestic Product: Fourth Quarter 2003" release, March 25, 2004.

21. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 220.

22. A recent study confirming the importance of the exchange rate for agriculture is M. Kim and W. Koo, "How Differently Do the Agricultural and Industrial Sectors Respond to Exchange Rate Fluctuation?" (Agribusiness & Applied Economics Report no. 482 (Fargo, North Dakota: North Dakota State University, Center for Agricultural Policy and Trade Studies, June 2002).

23. C.E. Hart, "U.S. Agriculture and the Value of the Dollar," Iowa Ag Review Online, summer 2003 (9.3), www.card.iastate.edu/iowa_ag_review/summer_03.

24. The Institute for International Economics, Washington, DC, published in February 2003 the proceedings of a conference titled *Dollar Overvaluation and the World Economy*. The proceedings document the dollar's overvaluation and the negative economic consequences.

25. Dr. C. Fred Bergsten of the Institute for International Economics estimated China's currency to be under-valued by between twenty and twenty-five percent. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 44. Franklin J. Vargo of the National Association of Manufacturers mentions estimates of under-valuation ranging as high as forty percent: U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, p. 175.

26. China's fast economic growth has recently caused it to move officially into trade deficit. However, this deficit is small, and the fact that it is so small despite a nine percent growth rate, is indicative of the extent of undervaluation.

27. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment and Exchange Rate Policies: Impact on the United States*, testimony of Ernest H. Preeg, September 25, 2003, p. 74.

28. "Double Surplus Situation to Maintain Stability of RMB Exchange Rate: Official," *People's Daily Online*, <http://english.peopledaily.com.cn>.

29. Source: International Monetary Fund, International Financial Statistics, April 2004, <http://www.imf.org/eng/Home>.

30. Material in this section is substantially based on the written statement provided to the U.S.-China Economic Security and Review Commission by Ernest H. Preeg. U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, pp. 72-6.

31. *Report to Congress on International Economic and Exchange Rate Policies*, (Washington, DC: U.S. Department of the Treasury, April 15, 2004), p. 1.

32. Source: *IMF Financial Statistics*.

33. Source: *World Investment Report, 2003* (New York and Geneva, Switzerland: United Nations, United Nations Conference on Trade and Development, 2003).

34. Source: U.S.-China Business Council, <http://www.uschina.org/statistics/fdi1979-03.html>.

35. See prepared statement of Kathleen A. Walsh, senior associate, The Henry L. Stimson Center, U.S.-China Economic and Security Review Commission, *Hearing on China's Industrial, Investment, and Exchange Rate Policies: Impact on the United States*, September 25, 2003, pp. 149-50.

36. Source: Commission's calculations using data from the Bureau of Labor Statistics, <http://data.bls.gov/>

37. These figures are contained in the report *The China Threat to World Textile and Apparel Trade* issued by the American Textile Manufacturers Institute and printed in the record of the Commission's hearing *China's Impact on the U.S. Manufacturing Base* held on January 30, 2004, pp. 49–58.

38. Cited in "China's Rivals in Asia Unprepared for End of Textile Quotas," *AFX News Limited*, March 28, 2004.

39. There were thirty-one signatories as of April 14, 2004.

40. See "Auto Exports to Get Strong Stimulus," *China Daily*, April 5, 2004.

41. All data are from the *Asian Development Outlook, 2004*, (Washington, DC: Asian Development Bank).

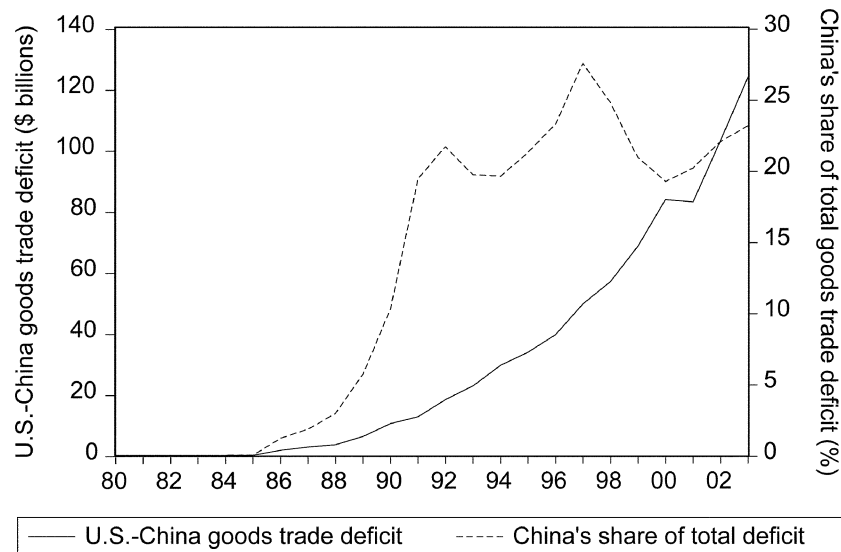
42. "Headed for a Crisis?" *Business Week*, May 3, 2004.

43. Data on total export growth are from the *Asian Development Outlook, 2004*. Data on the multinational export share are from a presentation, *Chinese Economy*, by Nicholas Lardy, senior fellow, Institute for International Economics, Washington, DC.

Figure 1.1 U.S. balance of goods trade by region for 2003

	Balance (\$ billions)	% of Total
Total (census basis)	–\$535.5	100.0%
North America	–95.0	17.8
Canada	–54.5	10.2
Mexico	–40.6	7.6
Western Europe	–101.3	18.9
Euro area	–75.4	14.1
Pacific Rim	–230.0	43.0
Japan	–66.0	12.3
China	–124.0	23.2
OPEC	–51.0	9.5
Rest of the World	–57.9	10.8

Legend: OPEC = Organization of Petroleum Exporting Countries
 Sources: Bureau of Economic Analysis and Commission's calculations.

Figure 1.2 U.S.-China goods trade deficit and China's share of the total U.S. goods trade deficit, 1980–2003

Source: U.S. Census Bureau, Foreign Trade Division.

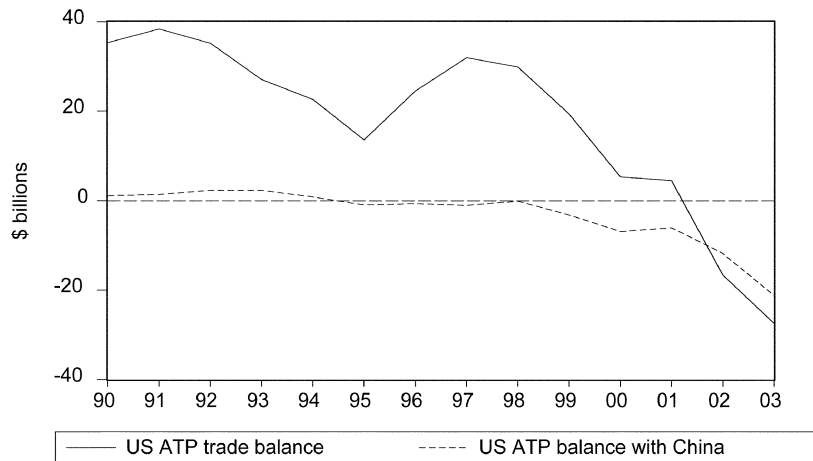
Figure 1.3 Comparison of scale of imbalance of the U.S. trade deficit by country import/export ratios, 2001–2003

Country	2001	2002	2003
China	5.32	5.66	5.36
Canada	1.33	1.30	1.32
Mexico	1.29	1.38	1.42
EU-15	1.38	1.57	1.63
Japan	2.20	2.20	2.27

Legend: EU = European Union

Sources: Bureau of Economic Analysis and Commission's calculations.

Figure 1.4 U.S. ATP trade balance and U.S. ATP trade balance with China, 1990–2003



Source: Data supplied by Charles McMillion, MBG Information Services and data in *The Threatened U.S. Competitive Lead in Advanced Technology Products (ATP)* (Arlington, VA: Manufacturers Alliance/MAPI, March 2004).

Figure 1.5 Changes in major currency dollar exchange rates, January 2, 2002–April 30, 2004

	January 2, 2002	April 30, 2002	% Change
Euro	0.90	1.20	33.3%
Japanese yen	132.02	110.37	16.4%
Canadian dollar	1.60	1.37	14.4%
Chinese yuan	8.28	8.28	0.0%

Sources: Board of Governors of the Federal Reserve and Commission's calculations.

Figure 1.6 Percentage change in total private and manufacturing employment two years into business cycle economic recovery

	% Change Private Employment	% Change Manufacturing Employment
Oct 1949–Oct 1951	12.00%	16.20%
May 1954–May 1956	7.10	6.10
Apr 1958–Apr 1960	7.20	7.90
Feb 1961–Feb 1963	4.50	5.00
Nov 1970–Nov 1972	6.50	5.80
Mar 1975–Mar 1977	7.20	7.50
Nov 1982–Nov 1984	9.40	7.70
Mar 1991–Mar 1993	1.10	–2.00
Nov 2001–Nov 2003	–1.00	–9.30

Source: Commission's calculations based on Bureau of Labor Statistics data.

Figure 1.7 Annual Official Chinese, Japanese, Taiwanese, and South Korean Foreign Exchange Purchases (\$ billions)

Year	China	Japan	Taiwan	S. Korea
2000–01	\$46.6	\$40.5	\$15.5	\$6.6
2001–02	74.2	63.7	39.4	18.3
2002–03	116.8	201.3	45.0	33.7

Source: *IMF Financial Statistics* and Commission's calculations.